Internal Revenue Service
memorandum

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date: NOV 7 1988

to: District Counsel, Chicago MW:CHI

from: Assistant Chief Counsel (Tax Litigation) CC:TL

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subject: Technical Advice
[redacted] v. Commissioner
T.C. Dkt. No. [redacted]

This is in response to your request for technical advice dated September 30, 1988.

ISSUE

Whether, under the circumstances described below, the taxpayer made adequate "disclosure of relevant facts" so as to avoid the addition to tax under § 6661.

FACTS

For the years in issue, taxpayer, an individual, filed his returns using income averaging. He attached Schedule G to claim the treatment. The Schedule G used inaccurate amounts for base period income, and the taxpayer's income averaging calculations were inaccurate. Upon examination, these inaccuracies were discovered and adjusted. We assume that the taxpayer was underreporting his base period income.

In a Stipulation of Settled Issues filed with the Court, petitioner conceded liability for the § 6661 penalty for both years. The settlement adjustments totaled $[redacted] for [redacted] and $[redacted] for [redacted]. The amount of the [redacted] adjustment resulted in the unavailability of income averaging in [redacted]. In turn, the unavailability of income averaging in [redacted] resulted in a deficiency of $[redacted]. As the adjustments for [redacted] totaled a mere $[redacted], the size of the deficiency was unexpected.

LEGAL ANALYSIS

Section 6661(a) imposes an addition for a substantial understatement of income tax. For penalties assessed after October 21, 1986, the rate of the addition is 25%. Pallotini v. Commissioner, 90 T.C.___ (March 30, 1988).

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A substantial understatement exists if the amount of the understatement exceeds the greater of 10% of the amount required to be shown on the return or $5,000. § 6661(b)(1). An understatement is the difference between the amount of tax required to be shown on the return for the taxable year and the amount of tax that is actually shown on the return (reduced by any rebate within the meaning of § 6211(b)(2)). § 6661(b)(2).

In the case of an item not attributable to a tax shelter, § 6661(b)(2)(B) provides that the amount of the understatement is reduced by the amount of the understatement attributable to any item if the taxpayer discloses, on the return or in an attachment, the identity and amount of the item as well as the specific facts or the position taken relevant to the tax treatment of the item.

Treasury Regulation § 1.6661-4 provides that disclosure may be made by a statement attached to the return or by providing sufficient information on the return. Treas. Reg. § 1.6661-4(c) provides, further, that the Commissioner, by Revenue Procedure, may prescribe "the circumstances in which information provided on the return" will constitute adequate disclosure. Rev. Proc. 85-19, 1985-1 C.B.520, does not list the AMT as one of the issues which can be disclosed by return.

The Tax Court, in Schirmer v. Commissioner, 89 T.C. 277 (1987) considered a claim of adequate disclosure in the context of farming issues. The Schirmers had attached schedules claiming farm losses, but the Government argued they lacked a profit motive. The Schirmers did not attach a statement of disclosure for purposes of § 6661 to their return. The forms on which they claimed farm losses were adequate disclosure, under the relevant Rev. Proc., only for a reserve for bad debts. The Tax Court held that under those accepted methods of disclosure, the taxpayers had not satisfied the statute. However, the Court went further:

> Where a taxpayer fails to comply with the Revenue Procedures issued in accordance with section 1.6661-4(c), Income Tax Reg., and fails to make specific reference to section 6661, the requirements of adequate disclosure on the return can nonetheless be satisfied by providing on the return sufficient information to enable respondent to identify the potential controversy involved. S. Rept. 97-494 at 274 (1982).

89 T.C. at 285-6. In a footnote, the Court also said:

> Sec. 6661 was added to the Internal Revenue Code by the Tax Equity and Fiscal Responsibility Act of 1982, Pub L. 97-248, 96 Stat. 324. The general explanation of this act, prepared by the Staff of the Joint Committee on Taxation,

> also lends support to our holding. The general explanation provides that the standard of disclosure under sec. 6661(a)(2)(B)(ii) requires "greater disclosure than is necessary to avoid the six-year statute of limitations provided for in section 6501(e)(1)(A)". Staff of Joint Comm. on Taxation, General Explanation of the Tax Equity and Fiscal Responsibility Act of 1982, at 218 (J.Comm. Print, 1982). The extended statute of limitations pursuant to sec. 6051(e)(1)(A) is triggered by the omission of more than 25 percent of the gross income stated in the return. Sec. 6501(e)(1)(A)(ii) states, however, that in "determining the amount omitted from gross income, there shall not be taken into account any amount which is omitted from gross income stated in the return if such amount is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary of the nature and amount of such item." The disclosure required to trigger sec. 6501(e)(1)(A)(ii) and avoid application of the extended period of limitations provided by sec. 6501(e)(1)(A) has been held to require production of a 'clue' with respect to the omission of gross income. University County Club, Inc. v. Commissioner, 64 T.C. 460, 470 (1975), citing Colony, Inc. v. Commissioner, 357 U.S. 28 (1958).

89 T.C. at 286, fn. 7. Based on this reasoning the Tax Court held that the Schirmers had not adequately disclosed the profit-motive issue with respect to their farm activity.

The Tax Court has applied its Schirmer, supra, reasoning to other cases. In Gentry v. Commissioner, T.C. Memo. 1988-188, the Court held, citing Schirmer, supra, that the taxpayers had not provided enough information to enable the government to identify the controversy. The information provided was the name and identification of a partnership, and the amount of the claimed partnership loss. The issue was whether the claimed partnership transaction was devoid of economic substance. T.C. Memo. 1988-188, 55 TCM (CCH) 744. In Burwell v. Commissioner, 89 T.C. 580 (1987) Tax Court cited Schirmer, supra, in a footnote, and held the taxpayer liable for the § 6661 addition, on the grounds that his material misrepresentation of the relevant facts, as set forth on his return, was not adequate disclosure. 89 T.C. at 596.

The Tax Court's treatment of the Schirmer, supra, opinion strongly suggests that the Tax Court believes there are three tests for adequacy of disclosure, the statement test, the return/revenue procedure test, and the Schirmer test. The Schirmer test, that the return must contain enough facts to allow the Commissioner to identify the potential issue, is basically factual. The Court has said the taxpayer must give us more than a clue to the identity of the issue. When analyzing under this test, the Court's opinions have examined the issue in the case and the contents of the return, and have sought to determine whether the return leads to a clear identification of the issue.

In your case, we agree that the taxpayer could not prevail under the statement test or the return/revenue procedure test. You have argued correctly that under Rev. Proc. 85-19, income averaging is not adequately disclosed by the attachment of a Schedule G. Further, we think that under Schirmer, supra, the taxpayer could not prevail. The Schirmer test requires the taxpayer to disclose enough information to allow the Commissioner to identify the issue. At most, the disclosure here told us that the taxpayer had used income averaging. It did not tell us that the taxpayer had incorrectly reported his base period income, which we assume he did. It did not tell us that there were adjustments that would disallow the income averaging treatment. Indeed, to arrive at the adjustments in this case, an examination was required.

The Schirmer test requires the taxpayer to give us more than a clue to the existence and identity of the issue. It appears that this taxpayer's return did not even do that much. We do not think this taxpayer can prevail on a Schirmer theory. Consequently we think the position you have taken is correct.

We think that, on brief, you should argue that the facts show the taxpayer has not met the Schirmer test. The Gentry, supra, and Burwell, supra, cases should bolster this contention, because both cases deal with a failure to disclose the precise issue before the Court. Hopefully, you will also be able to argue from the facts something to the effect that certain of petitioner's acts make him highly deserving of the results in this case.

We will contact Ms. Poronsky upon her return to the office next week in order to give any possible further assistance. Please send the brief through this office for review.

CONCLUSION

We agree with your conclusion. We recommend you argue that the Schirmer test has not been met on these facts. Please feel free to contact us informally if we can be of assistance. Blaise M. Gately of this office is familiar with this matter and can be reached at (FTS) 566-3335.

MARLENE GROSS

By: ______________________
SOMMERS T. BROWN
Acting Chief, Branch No. 3
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Attachment:
Copy of request for advice